Office - Supreme Court, U.S.
FILED
OCT 6 1982
ALEXANDER L. STEVAS,
CLERK

82-622

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

THE BALTIMORE AND OHIO RAILROAD COMPANY, W. JAMES PRICE, ALONZO G. DECKER, JR., JAMES PARKER NOLAN, FREDERICK DEANE, JR., JAMES L. O'KEEFE, GREGORY S. DEVINE, FAY A. LE FEVRE, NICHOLAS T. CAMICIA, DR. MILTON S. EISENHOWER, STEVEN MULLER, JOHN K. STEVENSON, HAYS T. WATKINS, HOWARD E. SIMPSON and CYRUS S. EATON, all Directors or former Directors of The Baltimore and Ohio Railroad, The Chesapeake and Ohio Railroad and/or the Chessie System, THE CHESAPEAKE AND OHIO RAILWAY COMPANY and CHESSIE SYSTEM, INC.,

Petitioners,

v.

PITTSBURGH TERMINAL CORPORATION,

Respondent

THE BALTIMORE AND OHIO RAILROAD COMPANY, W. JAMES PRICE, ALONZO G. DECKER, JR., JAMES PARKER NOLAN, FREDERICK DEANE, JR., JAMES L. O'KEEFE, GREGORY S. DEVINE, FAY A. LE FEVRE, NICHOLAS T. CAMICIA, DR. MILTON S. EISENHOWER, STEVEN MULLER, JOHN K. STEVENSON, HAYS T. WATKINS, HOWARD E. SIMPSON and CYRUS S. EATON, all Directors or former Directors of The Baltimore and Ohio Railroad, The Chesapeake and Ohio Railroad and/or the Chessie System, THE CHESAPEAKE AND OHIO RAILWAY COMPANY and CHESSIE SYSTEM, INC.,

Petitioners,

v.

MONROE GUTTMANN, LORETTA GUTTMANN, JANET REES and EVELYN BITTNER,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

RICHARD T. WENTLEY, Esquire
ANTHONY J. BASINSKI, Esquire
REED SMITH SHAW & MCCLAY
747 Union Trust Building
Pittsburgh, Pennsylvania 15219
(412) 288-3098

Counsel for Petitioners,
The Baltimore and Ohio Railroad Company,
The Chesapeake and Ohio Railway Company
and Chessie System, Inc.

SMITH BROS., LAW PRINTERS, 620 SECOND AVENUE, PITTSBURGH, PA. 15219

QUESTIONS PRESENTED

I. Must a specific intent to deceive or manipulate be shown in order to satisfy the scienter requirements of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 and is the good faith reliance upon the advice of counsel evidence of the lack of such intent.

   a. Is the decision of the Court of Appeals for the Third Circuit with regard to the question of scienter in direct conflict with the decision of this Court in *Ernst & Ernst v. Hochfelder.*

II. Does a convertible debentureholder have a claim under Section 10(b) or Rule 10b-5 attacking the failure to give notice of a dividend where there has been complete compliance with the Indenture under which the debentures were issued.

   a. Is the decision of the Court of Appeals for the Third Circuit in direct conflict with the decision of the Fifth Circuit in *Broad v. Rockwell International Corp.*

III. Whether the notice provisions of SEC Rule 10b-17 impose an affirmative duty to speak under Rule 10b-5 as required by this Court in *Chiarella v. United States;* and, if not, whether a private right of action for damages lies for violation of Rule 10b-17.

IV. Whether the requirement that there must be a purchase or sale in order for the terms of Rule 10b-5 to be applicable has been met merely because a Debentureholder possesses the option to convert his security into shares of common stock.

LISTING UNDER SUPREME COURT RULE 28.1

The CSX Corporation owns 100% of The Chesapeake and Ohio Railway Company.

The Baltimore and Ohio Railroad has the following subsidiaries and affiliates which come within Rule 28.1:

a. The Baltimore and Philadelphia Railroad Company;

b. Cleveland Terminal & Valley Railroad Company;

c. Dayton and Michigan Railroad Company;

d. Dayton and Union Railroad Company; and

e. Western Maryland Railway Company.

The Chesapeake and Ohio Railway Company has the following subsidiaries and affiliates which come with Rule 28.1:

a. Chicago South Shore & South Bend Railroad;

b. Richmond-Washington Company;

c. Richmond, Fredericksburg & Potomac Railroad Company; and

d. Richmond Land Company.

TABLE OF CONTENTS

	PAGE
QUESTIONS PRESENTED	i
LISTING UNDER SUPREME COURT RULE 28.1	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
STATEMENT OF JURISDICTION	1
STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	4
REASONS FOR GRANTING THE WRIT	10
I. The Decision of the Third Circuit on the Issue of Scienter is in Direct Conflict with the Express Pronouncements of This Court	10
II. The Holding of the Third Circuit is Directly Contrary to the Holding of the Court of Appeals for the Fifth Circuit in Broad v. Rockwell International Corp., in that it Gives Rights to Debentureholders Beyond the Scope of the Indenture	16
III. The Application of Rule 10b-17 Not Only Erroneously Creates An Implied Right of Action But Also Constitutes a Radical Departure From Existing Law	18
IV. Plaintiffs Lack Standing to Sue Because There Has Been No Purchase or Sale of a Security	21
CONCLUSION	24
Appendix A Opinion of the United States Court of Appeals for the Third Circuit, filed June 3, 1982	1a
Appendix B Opinion and Judgment Order of the United States District Court for the Western District of Pennsylvania, dated March 10, 1981	51a
Appendix C Rule 10b-17, 17 C.F.R. § 240.10b-17 (1981)	90a

PAGE

Appendix D
Order of the United States Court of Appeals for the Third Circuit denying petition for rehearing, dated July 9, 1982 ..... 93a

TABLE OF AUTHORITIES

CASES

Aaron v. SEC, 446 U.S. 680 (1980) 11, 12

Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied.*, 343 U.S. 956 (1952) 22, 23

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 21, 22

Broad v. Rockwell International Corp., 642 F.2d 929 (5th Cir. 1981) (en banc), *cert. denied.*, ____ U.S. ____, 102 S. Ct. 506, 70 L.Ed.2d 380 (1981) .. passim

California v. Sierra Club, 451 U.S. 287, 68 L.Ed.2d 101 (1981) 20

Chiarella v. U.S., 445 U.S. 222 (1980) 14, 19, 20

Costle v. Pacific Legal Foundation, 445 U.S. 198, (1980) 18

Ernst & Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375, 47 L.Ed.2d 668 (1976) ..... passim

Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2d Cir. 1975) 20

Helvering v. Southwest Corp., 315 U.S. 194 (1942) 17

Lutgert v. Vanderbilt Bank, 508 F.2d 1035 (5th Cir. 1975) 19

Parkinson v. West End St. Railway Co., 173 Mass. 446, 53 N.E. 891 (1899) 17

Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) 20

Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) 20

OTHER AUTHORITIES

STATUTES, RULES AND RELEASES — PAGE

Maryland Corporations & Associations, § 2-511 6

Securities Exchange Act of 1934,
15 U.S.C. § 78j(b) (1976) ..... passim

Securities Exchange Commission Rules,
17 C.F.R. § 230.240 (1981) 6
17 C.F.R. § 240.10(b) (1981) ..... passim
17 C.F.R. § 240.10b-17 (1981) ..... passim

Securities Exchange Act Releases,
No. 9076, 35 Fed. Reg. 3430 (Feb. 17, 1971) 19
No. 9192, 36 Fed. Reg. 11513 (June 7, 1971) 19

OTHER

HAWES & SHERRARD,
"Speech May Suggest 'Advice of Counsel' Evolution", Legal Times, March 1, 1982 at 11, Col. 1 ..... 14, 15

HAWES & SHERRARD,
Reliance on Advice of Counsel as a Defense in Corporate & Securities Cases, 62 Va.L.Rev. 1 (1976) 15

LONGSTRETH,
Reliance on Advice of Counsel as a Defense to Securities Law Violations, 37 Bus. Law. 1185 (1982) 14, 15

OPINIONS BELOW

The opinion of the Court of Appeals, reported at 680 F.2d 933, appears in Appendix A hereto. The opinion of the district court, reported at 509 F.Supp. 1002, appears in Appendix B hereto.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 3, 1982. A timely petition for rehearing was denied on July 9, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 10 of the Securities Exchange Act of 1934 provides:

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78j (1971).

Rule 10b-5 provides:

Rule 10b-5, Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security. 17 C.F.R., § 240.10b-5 (1981).

Rule 10b-17 is attached hereto as Appendix C.

STATEMENT OF THE CASE

These actions were brought by several holders of certain Baltimore and Ohio Railroad Company ("B&O") Convertible 4½% Debentures ("the Debentures")[1], alleging *inter alia*,[2] violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) and Rule 10b-5 promulgated thereunder by the Securities Exchange Commission ("SEC") 17 C.F.R. § 240.10(b) (1981). The Debentureholders have contended that they were entitled to advance notice of a dividend in the stock of a B&O wholly-owned subsidiary, Mid-Allegheny Corp. ("MAC"), which was declared by the B&O Board of Directors on December 13, 1977 and made payable to the B&O's common shareholders of record on that date. Such advance notice was claimed to be necessary in order that the Debentureholders would have the opportunity to decide whether or not to convert their Debentures and receive this dividend.

The declaration of the dividend of MAC shares was an essential part of a corporate reorganization that commenced in 1973 with the formation of Chessie System, Inc. ("Chessie") as a holding company to manage and control the assets of The Chesapeake and Ohio Railway Company ("C&O") which would not be subject to the jurisdiction of the Interstate Commerce Commission ("ICC"). In 1962, the C&O had acquired most of the common stock of the B&O and in December, 1977, 99.63% was under its control. [The remaining shares were held by thirteen minority shareholders.]

---

1. These Debentures are in the face value of $1,000 and before maturity in the year 2010, each is convertible at any time into ten shares of B&O common stock.

2. The other pendent claims are for breach of the Indenture, a breach of the New York Stock Exchange Listing Agreement and fraud and unconscionability.

Shortly after the formation of Chessie in 1973, it was decided to segregate in a separate corporation, Chessie Resources, Inc. ("Chessie Resources"), the assets of the C&O and its subsidiaries, including the B&O, which were not essential to or were not being used in rail operations. In late 1976, a Corporate Restructuring Committee ("the Committee")[3] was formed for the purpose of identifying properties and developing a plan for transferring non-rail B&O assets to Chessie Resources for development. In order to avoid problems with an intra-system sale of the properties, the Committee recommended that the non-rail assets be transferred to MAC, a wholly-owned subsidiary of the B&O. The B&O, in turn, would declare a dividend-in-kind of the shares of the subsidiary on its common stock.[4] This method of transfer was selected because by receiving the dividend, all of the B&O shareholders, the C&O and the minority, would thus retain their proportionate interest in all of the properties of the B&O. Following the payment of the dividend ownership would be evidenced by two certificates, one representing rail properties and the other non-rail properties.

Because counsel for the B&O, Robert F. Hochwarth ("Hochwarth") was concerned that the dividend-in-kind might require the filing of a registration statement with the SEC, he consulted with attorneys from the law firm of Hunton & Williams in Richmond, Virginia, who were retained because of their expertise in the field of securi-

---

3. The Committee was composed of the heads of the various departments of the B&O or their key subordinates.

4. The C&O would declare a dividend of the MAC shares it received to its sole shareholder, Chessie. Chessie would then contribute the MAC shares to Chessie Resources for development of the properties.

ties law. He wished to have their assistance in obtaining a "no action" letter from the SEC with regard to the MAC dividend in order to avoid the necessity of filing a registration statement. That statement would have required several years to prepare because it would have been necessary to obtain appraisals of the various properties in order to determine the fair market value of the dividend.

So that the MAC dividend would be eligible for a no action letter,[5] counsel for the B&O proposed that the declaration, record and payment dates be on the same day. This was found by counsel to be in accord with the law governing dividends by a Maryland corporation such as the B&O. Maryland Corporations and Associations, § 2-511.

Hochwarth also reviewed the terms of the Indenture which governed the rights of the Debenture-holders. He particularly examined Article 5, Section 12 of the Indenture which provides as follows:

> "The Company covenants and agrees that it *will not declare and/or pay any dividend on its common stock payable in stock* or create any rights to subscribe for stock or securities convertible into stock unless in any such case notice of the taking of a record date for the determination of the stockholders entitled to receive such dividend, distribution or right is given at least ten days prior thereto by at least one publication in an Authorized Newspaper. A copy of each published notice shall promptly after such publication be filed with the Trustee." (Emphasis added)

---

5. 17 C.F.R. § 230.240 (1981).

Beginning in April, 1977, Hochwarth and John L. Rogers, an attorney and then head of the Committee, reviewed this provision and concluded that the word "stock" in the phrase "payable in stock" referred only to the stock of the B&O and not to a dividend of the stock of a subsidiary corporation. Legal research by Hochwarth, later confirmed by another attorney, showed that a dividend in the stock of another corporation such as the MAC dividend is considered to be the equivalent of a cash dividend. Therefore, it was concluded that notice was not required to the Debenture-holders. This information was communicated to Roland Donnem ("Donnem"), Vice President, Law and Doyle Morris, General Counsel for the B&O, both of whom agreed with this interpretation of the Indenture.

Hochwarth and Donnem also considered the requirements of the New York Stock Exchange ("NYSE") contained in the listing agreement with the NYSE for the B&O common stock that advance notice of certain dividend actions had to be made to it. Although the entire listing agreement was incorporated by reference in the listing agreement for the Debentures, Hochwarth and Donnem concluded that the notice requirement was inapplicable to the MAC dividend because it applied only to dividends declared on listed stocks and the B&O common stock had neither been listed nor traded for at least two years prior to the declaration of the dividend.

In November, 1977, Hochwarth outlined in a letter to a senior partner in the firm of Hunton & Williams, John W. Riely, the proposed dividend plan, including the fact that the date of record and payment would be the same as the date of declaration and asked Riely to "[p]lease let me know if you see any problems with this procedure."

No objections were ever made by Riely or any other attorney at Hunton & Williams to this proposal.

The MAC dividend was declared on December 13, 1977 only after the B&O directors[6] had been assured that none of the rail properties was being transferred and that counsel had passed on the legality of the proposed plan. In addition to the MAC dividend, the B&O also declared and paid a dividend of $4 a share to preferred shareholders of record as of December 13, 1977, the date of declaration.

The B&O issued a news release dated December 14, 1977 announcing the declaration of the MAC dividend. A copy of this release was sent to Monroe Guttmann ("Guttmann"), a named plaintiff in one of these actions and president of the Corporation named as plaintiff in the other because in November, 1977 he had inquired as to whether the B&O intended to resume the payment of dividends on its common stock after a 16 year hiatus. He was told that he would be notified of any dividend action at the same time as notice was generally announced.

Following the declaration of the MAC dividend, Hunton & Williams applied for a no action letter from the SEC and on June 29, 1979, submitted a supplemental request disclosing in detail the pendency of the actions at bar. By letter of September 7, 1979, the SEC stated that it would not take any enforcement action if the dividend was distributed without registration.

These suits were instituted on December 28, 1977 by the Pittsburgh Terminal Corporation in the United States District Court for the Western District of Pennsylvania seeking a preliminary injunction enjoining the

---

6. None of the B&O directors with the exception of its Vice-Chairman, Hays T. Watkins, was employed by the B&O.

payment of the MAC dividend. The District Court granted the motion, but was subsequently reversed by the Court of Appeals for the Third Circuit ("Third Circuit").

Following the reversal on January 22, 1979 plaintiff Guttmann and other Debentureholders brought a separate suit, which was consolidated for trial with the Pittsburgh Terminal action.

These matters were heard by the District Court sitting without a jury on July 21-24, 1980. The trial court entered judgment in favor of all defendants and dismissed the complaint finding, *inter alia*, that the Indenture did not require notice to the Debenture holders and the plaintiffs failed to establish that the defendants possessed the requisite scienter to establish a violation of Section 10(b) and Rule 10b-5.

On appeal to the Third Circuit, the three-judge panel which heard the matter was sharply divided in its decision of June 3, 1982. It nonetheless reversed the decision of the District Court and remanded for a determination of the appropriate remedy. Judge Gibbons who authored the Opinion Announcing the Judgment of the Court found that the defendants had violated Rule 10b-5 by failing to give advance notice of the MAC dividend in accordance with SEC Rule 10b-17, 17 C.F.R. § 240.10b-17 (1981), the New York Stock Exchange Listing Agreement for the Debentures, the Maryland law of fiduciary obligations and the New York law of contracts. Judge Garth in his concurring opinion, predicated defendants' duty to disclose the dividend solely on the requirements of Rule 10b-17 (an issue raised for the first time on appeal). Judge Adams vigorously dissented with respect to all issues and pointed out that the panel's holding rests on the narrow ground of a violation of Rule 10b-17.

Defendants petitioned the Third Circuit for rehearing on June 16, 1982, which petition was denied on July 9, 1982.

REASONS FOR GRANTING THE WRIT

1. The Decision of the Third Circuit on the Issue of Scienter is in Direct Conflict with the Express Pronouncements of This Court.

The Third Circuit held in this case on the issue of scienter that "[t]he decision to time the MAC transaction so as to prevent notice to the Bondholders until too late was both knowing and intentional. No more is required by the governing cases."[7] The Court then went on to state its understanding of scienter: "A violation of Section 10(b) does not require a specific intention to break the law. It requires only knowing or intentional actions which, objectively examined, amount to a violation."[8] In so holding it has ignored the fundamental teachings of this Court.

Although proof of a specific intention to break the law is not a requisite to establishing a violation of § 10(b), under the decisions of this Court, a specific intention to deceive, manipulate or defraud is. Where as here the defendants were assured that they were acting lawfully (based on the advice of counsel), the requisite element of scienter is absent.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that Section 10(b) "was addressed to practices that involved some element of scienter and

---

7. Appendix A at 20a.
8. Id. at 21.

cannot be read to impose liability for negligent conduct alone." 425 U.S. at 201. The Court defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." Id. at 194, n. 12.

The SEC had argued in *Hochfelder* in an *amicus curiae* brief that liability under Section 10(b) should be imposed where the defendant's conduct is merely negligent on the theory that because "the 'effect' upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally." 425 U.S. at 198.

This Court dismissed the SEC's argument, saying: "The argument simply ignores the use of the words 'manipulative', 'device', and 'contrivance' [in § 10(b)]—terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Hochfelder*, 425 U.S. at 199. The Court then sought a definition of these terms:

> "Webster's International Dictionary (2d ed. 1934) defines 'device' as '[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, *a scheme to deceive*; a strategem; an artifice', and 'contrivance' in pertinent part as '[a] thing contrived or used in contriving; a scheme, plan, or artifice,' In turn, 'contrive' in pertinent part is defined as "[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . .' " Id. at 19[illegible] n. 20. (emphasis added).

As explained by this Court in *Aaron v. SEC*, 446 U.S. 680, 690 (1980), "It was the view of the Court [in *Hochfelder*] that the terms 'manipulative', 'device', and 'contrivance' —whether given their commonly accepted meaning or

read as terms of art—quite clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct.' "

The SEC, apparently undaunted by the Court's decisions in *Hochfelder* and *Aaron*, filed an *amicus curiae* brief in the Third Circuit in this case in which it argued that plaintiffs do not have to prove a "plan to deceive" to establish liability under § 10(b). Implicit in the Third Circuit's decision is an adoption of this twice-rejected position of the SEC. The Third Circuit in the present case imposed liability simply because in its view, there were "knowing or intentional actions, which, objectively examined" constituted a violation of Section 10(b). This is simply another way of saying that if some court somewhere concludes that investors may be misled by some action of the defendant, the defendant is liable under § 10(b). This effect-oriented approach was specifically rejected in *Hochfelder*. 425 U.S. at 198. It is "misconduct" which this Court has held § 10(b) was designed to protect against, not mere "conduct." Furthermore such misconduct must be the result of a " 'scheme to deceive' ". *Id.* at 199 n. 20. The Third Circuit's decision has the effect of reading that requirement out of § 10(b). The deceit requirement is not a neutral, value-free term as the Third Circuit would have it. The word must mean that the defendants knew they were acting wrongfully. Simply because the defendants may have known that absent notice the Debentureholders would not have the opportunity to receive the dividend cannot be a predicate for liability where as here the defendants were assured that no duty to give notice existed.

As in the case of *Broad v. Rockwell International Corp.*, 642 F.2d 929 (5th Cir. 1981) (en banc), *cert. denied*, __ U.S. __, 102 S. Ct. 506, 70 L.Ed. 2d 380 (1981), "there

is no doubt but that there was concerted, intentional conduct" 642 F.2d at 963, on the part of the B&O to conceive of and declare the MAC dividend. But similarly, "as a matter of law, there was no violation of section 10(b) or Rule 10b-5 because there was no fraud." *Id.* at 963. As found by the District Court in the present case, "no intention has been shown by the plaintiffs to defraud them or failure to investigate the procedures before they were adopted".[9]

Where is the "device", "scheme" or "artifice" designed to deceive or manipulate?[10] The B&O's Board of Directors declared the MAC dividend on December 13, 1977. On December 14, 1977, notice of the dividend was made public by a news release, a copy of which was sent to plaintiff Guttmann. Furthermore, all of the minority shareholders were at all times to receive the dividend and in fact did. Nothing was concealed. The Debentureholders and the market generally were aware of the MAC dividend within days of its declaration.

In addition, the MAC dividend was declared only after counsel had conducted an investigation to determine whether or not it was necessary that advance notice of the dividend be given to Debentureholders under the Indenture, the NYSE Listing Agreement and Maryland corporate law, and had determined that no such notice was necessary. *Supra* at pp. 6-7. This information was conveyed to the officers and directors of the B&O. Thus, the information which they possessed was that they had no duty to give notice. In *Hochfelder*, this Court stated that "[t]here is no indication that Congress

---

9. Appendix B at 77a.

10. The inapplicability of Rule 10b-17 as such a device is discussed *infra* at pp. 18-21. In any event, that Rule cannot provide a substitute for the scienter requirement of Rule 10b-5.

intended anyone to be made liable for such practices unless he acted other than in good faith. The catchall provisions of § 10(b) should be interpreted no more broadly." 425 U.S. at 206. See also *Chiarella v. United States*, 445 U.S. 222, 234-5 (1980). Nonetheless, the Third Circuit declined to consider such evidence as being evidence of good faith, simply saying "advice of counsel that they will not incur liability cannot be recognized as a defense".

The requirement of scienter and the defense of good faith reliance on advice of counsel are inextricably linked. *Hawes & Sherrard*, "Speech May Suggest 'Advice of Counsel' Evolution", *Legal Times*, March 1, 1982, at 11, Col. 1. If, as in the present case, defendants have made a good faith effort to ascertain their obligations under the law, wherein lies the intent to decieve? This connection between scienter and good faith reliance on counsel has been specifically recognized by Commissioner Bevis Longstreth of the Securities Exchange Commission, who, in discussing the facts of the present case in a recent speech in Los Angeles, made the following pertinent observation:

> If scienter means knowing, intentional, or reckless misconduct, in a case where the rights of the debentureholders to notice are carefully set out in an indenture, it seems the essence of good faith and due care—quite the opposite of misconduct—for the defendant to seek expert counsel on whether notice need be given and then reasonably to rely on that advice. If counsel is wrong as to the duty, an action based upon the contract will lie, regardless of counsel's advice and the defendant's good faith reliance on it. But to charge scienter under these circumstances, thereby affording a basis for an action under 10b-5, seems misplaced.

Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 Bus. Law. 1185, 1196 (1982). Commissioner Longstreth, thus clearly recognizes that the reliance on the advice of counsel may supply the good faith which removes any wrongful element from the defendants' action.

Petitioners did not assert, nor do they now, that consultation with counsel immunizes all corporate actions from Rule 10b-5 liability. Petitioners do assert, however, that where such consultation is made and a determination is made that no duty to give notice exists, it is evidence of the defendants' good faith which negates any finding of scienter. In discussing the facts of this case the leading commentators on the advice of counsel defense noted,[11] "if legal advice concerning the duty to provide notice was an important element in the defendants' decision not to give notice, the fact that they knew what they were doing and knew the consequences of their actions does not amount to scienter because, based on that advice, they neither intended to, nor did they, act with deception." *Hawes & Sherrard*, supra at 11.

The failure of the Third Circuit to follow the decisions of this Court on the issue of scienter and its failure to recognize the advice of counsel defense has the effect of imposing liability on corporations and directors even where there is no intent to deceive and the utmost care is exercised by the officers and directors of the corporation. This is clearly a strict liability standard which if permitted to stand would only precipitate a flood of lawsuits on the theory that some court may award damages.

---

11. See *Hawes & Sherrard*, Reliance on Advice of Counsel As a Defense In Corporate and Securities Cases, 62 Va.L.Rev. 1 (1976).

II. The Holding of the Third Circuit is Directly Contrary to the Holding of the Court of Appeals for the Fifth Circuit in *Broad v. Rockwell International Corp.*, in that it Gives Rights to Debentureholders Beyond the Scope of the Indenture.

In *Broad v. Rockwell*, 642 F.2d 929 (5th Cir. 1981), (en banc) *cert. denied*, — U.S. —, 70 L.Ed.2d 380 (1981), the Court of Appeals for the Fifth Circuit was faced with the identical issue present here: Whether an indenture for certain convertible debentures was violated and if so, whether such violation also constituted a violation of Rule 10b-5.

The 24 (out of 25) members of the Fifth Circuit who heard *Broad* on rehearing all agreed that initially it must be determined whether there was compliance with the indenture because the debentureholders' rights are expressly limited by its terms. *Id.* at 945. The Fifth Circuit then extensively analyzed the rights of the debentureholders under the indenture and the general law applicable to convertible debentureholders. The Court concluded that the debentureholders had received "all to which they were contractually entitled under the Indenture." *Id.* at 963.

For the *Broad* court, the fact of compliance with the terms of the indenture was sufficient to preclude liability under section 10(b) as well:

> "It is elementary that section 10(b) and Rule 10b-5 reach only conduct involving manipulation or deception. E.G. *Santa Fe Industries, Inc., v. Green*, 430 U.S. 462, 97 S. Ct. 54, 50 L.Ed. 2d 74 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.C. 1375, 47 L.Ed. 2d 668 (1976). The defendants' conduct involved neither; they merely carried out their contractual obligations. *As a conceptual matter, they*

> *could not have fraudulently schemed to deprive the holders of debentures of a right that those holders did not in fact have." Id.* at 963. (emphasis supplied).

In the present case, there is no dispute but that the B&O, based upon the study by counsel, determined that there was no need to give notice to the Debentureholders of the dividend declaration under the terms of the Indenture. Not even the Third Circuit has indicated that that determination was erroneous, as the Indenture is not one of its predicates for liability. In nonetheless finding liability in this case under the securities laws, the Third Circuit has ignored the fundamental distinction that exists between the rights of a shareholder and those of a Debentureholder. This Court has quoted with approval Justice Holmes' fundamental pronouncement governing the rights and duties of a corporation *vis a vis* its convertible Debentureholders:

> " 'The bondholder does not become a stockholder by his contract in equity any more than at law . . . [T]he contract does not prevent the corporation from consolidating with another in such a way as to make performance [conversion] impossible, any more than it prevents the issue of new stock in such a way as to make performance [conversion] valueless.' "

Parkinson v. West End Street Railway Co., 173 Mass. 446, 53 N.E. 891, 892 (1899), quoted with approval in *Helvering v. Southwest Corp.*, 315 U.S. 194, 200 (1942).

The holding of the Third Circuit in this case, if permitted to stand, represents a fundamental departure from the well-established law governing convertible debentures and places the Third Circuit in direct conflict with the Fifth Circuit in the important matter of the

rights of convertible debentureholders. As noted by the Court in *Broad*, a uniform interpretation of those rights "is essential to the effective functioning of the financial markets . . ." 642 F. 2d at 943. The conflict between the circuits can only impair the efficient working of those markets.

III. The Application of Rule 10b-17 Not Only Erroneously Creates An Implied Right of Action But Also Constitutes a Radical Departure From Existing Law.

The two judges who formed the majority in the Third Circuit for reversal found a duty to give advance notice of the MAC dividend pursuant to SEC Rule 10b-17, 17 C.F.R. § 240.10b-17 (1981).[12] Rule 10b-17 provides that an "issuer of a class of securities publicly traded" must comply with the rule's requirement of notice to the New York Stock Exchange or the National Association of Securities Dealers of the declaration of a dividend "relating to such class of securities" 17 C.F.R. § 240.10b-17(a) (1981).[13] The Third Circuit held that this rule's provisions[14] supplied the "duty to speak" required by

---

12. Appendix C.

13. The issue of the applicability of Rule 10b-17 was never raised in the plaintiff's complaint or pre-trial statement; nor was any evidence ever produced at trial on the issue of whether there had been compliance with its terms. As this Court has consistently held, issues not properly raised below should not be considered by appellate courts. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n. 13 (1976); *Costle v. Pacific Legal Foundation*, 445 U.S. 198, 218 (1980).

14. Although the B&O convertible debentures are publicly traded, the dividend in the present case was declared on the B&O common stock which had not been

this Court's decision in *Chiarella v. United States*, 445 U.S. 222, 228 (1980) in order to establish liability under Rule 10b-5. This is a radical departure from existing law.[15]

In *Chiarella*, this Court held that "silence in connection with the purchase or sale of securities may operate as a fraud . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transactions." 445 U.S. at 230. The court in *Chiarella* refused to establish a "general duty between all participants in market transactions to forego action based on material, nonpublic information. Formulation of such a broad duty . . . departs radically

---

traded publicly for several years prior to the dividend declaration. Accordingly, the dividend was not an action "relating to" a class of publicly traded securities, and the notice provisions of Rule 10b-17 are inapplicable.

The majority of the Third Circuit panel, however, concluded that the dividend was "material to" the convertible debentures and the Debentureholders and equated that to the "relating to" language of Rule 10b-17. There is no support for such an equation. No reference to materiality is made in Rule 10b-17 itself or in the two releases which were published in connection with its promulgation. Securities Exchange Act Release No. 90 76, 36 Fed. Reg. 3430 (Feb. 17, 1971); Securities Exchange Act Release No. 9192, 36 Fed. Reg. 11513 (June 7, 1971).

Those releases make it clear that Rule 10b-17 was not designed to create new rights in the holders of publicly traded securities as the Third Circuit's holding does here.

15. There has been only one prior case to discuss the scope of Rule 10b-17 and that was in dictum. *Lutgert v. Vanderbilt Bank*, 508 F.2d 1035 (5th Cir. 1975). That decision did not purport to deal with the issue of the duty to speak requirement.

from the established doctrine that duty arises from a specific relationship between parties . . ."[16] *Id.* at 233.

Rule 10b-17 does not establish any type of specific relationship between the issuer and the security-holder which might give rise to the duty to speak. The notice required by that rule is to be given only to the NYSE or NASD; no direct notice to the security holder is required. The failure to give such notice merely subjects the issuer to the possibility of an SEC enforcement action. Any application of the Rule to the securityholders themselves necessarily must be derivative and contrary to the language of *Chiarella* requiring a "specific relationship" in order for there to be a duty to speak.

Since the failure to give notice of the record date in accordance with Rule 10b-17 does not constitute a breach of a duty of disclosure necessary to establish Rule 10b-5 liability, it is apparent that the Third Circuit has actually ruled that a violation of Rule 10b-17, in itself, gives rise to an implied private cause of action. Such a finding is at odds with recent decisions of this Court which hold that no implied cause of action for violation of a securities law is available absent clear Congressional intent to create such a private remedy. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche-Ross & Co., v. Redington*, 442 U.S. 560 (1979). See also *California v. Sierra Club*, 451 U.S. 287, 68 L.Ed.2d 101 (1981), Nothing in the language of Rule 10b-17 or in the circumstances of its enactment indicates that Congress' rule-making dele-

---

16. See also *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975) ("[t]he party charged with failing to disclose market information must be under a duty to disclose it *to the plaintiffs*") (emphasis added).

delegate, the SEC, intended to create a private cause of action. On the contrary, by providing that it may exempt an issuer from compliance with the rule, *see* 17 C.F.R. § 240.10b-17(b)(2) (1981), the SEC evidenced an intent that it alone should enforce Rule 10b-17 and that no private cause of action was intended.

IV. Plaintiffs Lack Standing to Sue Because There Has Been No Purchase or Sale of a Security.

The Third Circuit determined that the plaintiffs' mere status as convertible Debentureholders without more was sufficient to satisfy the standing requirements of Rule 10b-5 and § 10(b) that any fraud be "in connection with the purchase of sale of any security." This holding was premised on the dicta of this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975):

> "Unlike respondent, which had no contractual right or duty to purchase Blue Chip's securities, the holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to 'purchasers' or 'sellers', but because the definitional provisions of the 1934 Act themselves grant them such a status." 421 U.S. at 751.

Significantly, the Court did not specifically list convertible debentures as that type of contractual right which gives rise to standing nor in noting that holders of certain rights "have been recognized as 'purchasers' or 'sellers' " does the Court cite any prior decisions involving debentureholders. To give a Debentureholder this status appears to be contrary to the concerns which the Court expressed in adopting the reasoning set forth in

Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.) *cert. denied*, 343 U.S. 956 (1952). For example, the Court stated that:

> "[t]he Birnbaum rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable. But it also separates in a readily demonstrable manner the group of plaintiffs who actually purchased or actually sold, and whose version of the facts is therefore more likely to be believed by the trier of fact, from the vastly larger world of potential plaintiffs who might successfully allege a claim but could seldom succeed in proving it. And this fact is one of its advantages." *Id.* at 743.

The Court was clearly troubled by the fact that the claim of a plaintiff who had not actually bought or sold would depend upon uncorroborated oral testimony as to "[t]he manner in which the defendant's violation caused the plaintiff to fail to act," which would likely consist of matters "totally unknown and unknowable to the defendant." *Id.* at 746.

This same concern was expressed by Mr. Justice Powell in his concurring opinion in *Blue Chip*:

> "Proving, after the fact, what 'one would have done' encompasses a number of conjectural as well as subjective issues: would the offeree have bought at all; how many shares would he have bought; how long would he have held the shares; were there other 'buys' on the market at the time that may have been more attractive even had the offeree known the facts; did he in fact use his available funds (if any) more advantageously by purchasing something else?" *Id.* at 758 n. 2

These concerns as to "what one would have done" are certainly applicable to convertible debentureholders. There is simply no way of knowing whether or not a convertible debentureholder would choose to convert his debentures into common stock because of the payment of a dividend in kind on that stock. Unlike the holders of puts, calls and options who merely have a contractual right to buy or sell shares of a security at a fixed price by a specified date, a convertible debentureholder also has a right to receive interest until maturity. There is no way of determining whether a debentureholder would exchange this guaranteed right to interest for a dividend in kind that not even the B&O could place a value on.

The decision of the Third Circuit is contrary to the clear intent of this Court in adopting the *Birnbaum* rule. It gives purchaser or seller status to a convertible debenture holder even though there has been no transaction involving the purchase or sale of his debentures or any other security. This holding is directly contrary to the specific language of Section 10(b) which requires that any alleged fraud be "in connection with the purchase or sale of any security." Because of the apparent confusion existing in the lower courts on this requirement, we respectfully suggest that the Court take this opportunity to dispel these misapprehensions.

CONCLUSION

Because the decision of the Third Circuit is in direct conflict with the decisions of this Court and the Fifth Circuit on important issues relating to the securities laws, it is respectfully suggested that a writ of certiorari should issue to reverse the judgment and opinion of the Third Circuit.

Respectfully submitted,

RICHARD T. WENTLEY
ANTHONY J. BASINSKI
REED SMITH SHAW & MCCLAY
747 Union Trust Building
Pittsburgh, Pennsylvania 15219

Counsel for The Baltimore and Ohio Railway Company, The Chesapeake and Ohio Railway Company, and Chessie System, Inc.